

Multistate Tax Commission



TO: PPWG – UNIFORMITY COMMITTEE LIAISON GROUP
MEMBERS

FROM: ALAN H. FRIEDMAN, MODERATOR

SUBJECT: THREE UNITIES TEST DEFINITIONS

DATE: JUNE 17, 1999

Attached is a redraft dated June 17, 1999 of the Three Unities Test for a Unitary Business which we will discuss during our Group call on June 23rd at 1:30 PM (Eastern). The redraft is based upon what I discerned from our June 9th teleconference. You may join the next teleconference by calling 703-736-7307 and asking for the Multistate Tax Commission teleconference with me as the moderator. We will also discuss any changes you may wish to the last version of the Dependency/Contribution Test which I e-mailed/faxed to you a couple of weeks ago. You may find both drafts on the MTC website, www.mtc.gov by next Monday.

We have no further teleconferences scheduled after the 23rd. Unless I hear strong sentiment from the Group when we meet on the 23rd to the contrary, I plan on referring our work on these first two drafts to the full Uniformity Committee to determine what it wishes to do with them. In addition, if a sufficient number of this Group indicate to me that they wish to begin addressing the *Mobil* Three Factors Test, I will refer that request also to the full Uniformity Committee. As I have stated often to the Group and Subgroups, it does not make a lot of sense to keep this work confined to too small a group any further. Good work has been accomplished and that work should now be reviewed from a larger number of different viewpoints to ensure the development of a proposal that could be widely accepted. I will look to the active members of this PPWG – Uniformity Committee Liaison Group for further direction in that regard.

Again, please note that there are alternatives set forth in various places throughout the attached draft. Note in particular the alternative of California's treatment of ownership that incorporates the concept of control, as distinguished from treating control separate from "unity of ownership" and as an element of "unity of operations" or "unity of use".

According to our process, all alternative positions will remain in the drafts, unless no support for a given alternative remains. Please review the entirety of both the Three Unities Test draft and the Dependency/Contribution

Test draft for our discussion on June 23rd and be prepared to discuss your preference for alternatives and to suggest improvements to both drafts.

Lastly, for those of the Group who wish to submit anything in writing before the 23rd, please e-mail your materials to Teresa Nelson at tnelson@mtc.gov and Teresa will circulate the materials to the others. I will be traveling until next Tuesday and will not be able to handle the logistics myself. Since there are a few changes and additions to the draft of the Three Unities Test that we have not discussed, I suggest that those who wish to address their comments after our discussion on the 23rd do so to me. If I get your written comments before Bastille Day, I will forward on those comments to the Uniformity Committee for its information.

I look forward to continued good discussions on June 23rd.

PROPOSED THREE UNITIES TEST

June 17, 1999 Draft

I. Three Unities Test for Determining a Unitary Business.

A. Definitions.

For the purposes of this section, the following definitions shall apply and control:

1. “Business” means a single entity or two or more entities under common ownership or control with respect to which [this State’s income/franchise tax] law requires a determination of whether the activities of the entity or entities within and without this State constitute one or more unitary businesses within this State.
2. “Entity” means each type of organization that [this State’s income/franchise law] recognizes as a reporting person, except such term does not include an individual or [insert other applicable exceptions].
3. “Segment” means a subdivision of an entity consisting of any grouping of business activities, functions or transactions.

B. Facts and Circumstances; Presumptions; General Rules.

1. *Facts and Circumstances.* The determination under paragraph C. of whether an entity or segment forms part of a unitary business with another shall be determined by the facts and circumstances of each case.
2. *General Rules.* In order to determine whether the facts and circumstances of any given case support a conclusion that an entity or segment is unitary with another under the Three Unities Test, the following additional general rules shall apply:
 - a. *Existence of Arms’-Length Prices.* The fact that goods and/or services are supplied at arms’-length prices between or among entities or segments of entities sought to be included in or excluded from a unitary business is

[ALTERNATIVE A] not a relevant factor, and does not support either inclusion in or exclusion from a unitary business group.

[ALTERNATIVE B] a relevant factor which that is in support of exclusion from a unitary business group.

- b. *Non-Existence of Arms'-Length Prices.* The fact that goods and/or services are not supplied at arms'-length prices between or among entities or segments of entities sought to be included in or excluded from a unitary business is relevant, and is a fact that is in support of inclusion in a unitary business group.
- c. *Existence of Benefits from Joint, Shared or Common Activity.* The fact that a discount, cost-saving or other benefit CAN BE SHOWN TO result from joint purchases, leaseholds or other forms of joint, shared or common activities between or among entities or segments of entities is relevant, and is a fact that is in support of inclusion in a unitary business group.
- d. *Non-Existence of Benefits from Joint, Shared or Common Activity.* The fact that a discount, cost-saving or other benefit CANNOT BE SHOWN TO result from joint purchases, leaseholds or other forms of joint, shared or common activities between or among entities or segments of entities is not relevant, and is not a fact in support of either inclusion in or exclusion from a unitary business group.
- e. *Relationship of Joint, Shared or Common Activity to Income-Producing Operations.* In determining whether a joint, shared or common activity is a fact that does or does not support a finding regarding unitary, consideration shall be given to the nature and character of the basic operations of each entity or segment. Such consideration shall include, but not be limited to, the entities' and segments' sources of supply, their goods or services produced or sold, their labor force and market to determine whether the joint, shared or common activity is directly related to or reasonably necessary to the income-producing activities of the unitary business.

- f. *The Existence or Lack of Control.* THE FACT THAT CONTROL BY ONE ENTITY OR SEGMENT OVER ANOTHER ENTITY OR SEGMENT EXISTS IS RELEVANT, AND IS A FACT IN SUPPORT OF INCLUSION IN A UNITARY BUSINESS GROUP.

THE FACT THAT CONTROL BY ONE ENTITY OR SEGMENT OVER ANOTHER ENTITY OR SEGMENT DOES NOT EXIST IS RELEVANT, AND IS A FACT IN SUPPORT OF EXCLUSION FROM A UNITARY BUSINESS GROUP.

- g. *Stewardship Activities.* An investor who takes an action solely for its own benefit in overseeing its investment and which action is not taken to benefit the entity in which the investor owns an interest, shall be considered to be a “stewardship” activity. The fact that stewardship activities exist is not relevant to determining whether the elements of “unity of operations” or “unity of use” have been satisfied.
- h. *Holding Companies.* THE TEST FOR A UNITARY BUSINESS ESTABLISHED HEREUNDER SHALL BE APPLIED TO DETERMINE WHETHER A HOLDING COMPANY IS TO BE INCLUDED IN A UNITARY GROUP. THIS PROVISION APPLIES IRRESPECTIVE OF WHETHER THE HOLDING COMPANY IS AN ACTIVE, PURE OR PASSIVE HOLDING COMPANY.
- i. *Instant Unity.* [To be Added].

C. Three Unities Test.

A unitary business includes each entity or segment of a business among which there exists a unity of ownership; and a unity of operation or a unity of use, or both.

ALTERNATIVE A – MORE GENERAL TEST OF OWNERSHIP

1. The “unity of ownership” element of this test for combined reporting purposes is satisfied when an entity, directly or

indirectly, owns more than a fifty percent (50%) ownership interest in each entity sought to be included in the unitary business.¹

ALTERNATIVE B – CALIFORNIA’S STATUTORY APPROACH

*TO OWNERSHIP OR CONTROL [TO BE TAILORED TO FORMAT OF
REST OF PROVISIONS]*

**STATE-LAW, CA-TAXRPTR ¶[228-339, Sec. 25105.
[Determination of ownership or control.]**

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**[California Laws], REVENUE AND TAXATION CODE, DIVISION
2--OTHER TAXES, PART 11. BANK AND CORPORATION TAX
LAW, CHAPTER 17 ALLOCATION OF INCOME, Article 1
General Provisions.**

Sec. 25105. [Determination of ownership or control.]

(a) For purposes of this article, other than Section 25102², the income and apportionment factors of two or more corporations shall be included in a combined report only if the corporations, otherwise meeting the requirements of Section 25101 or 25101.15, are members of a commonly controlled group.

(b) A "commonly controlled group" means any of the following:

(1) A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if--

(A) The parent owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,

(B) Stock cumulatively representing more than 50 percent of

¹ The unity of ownership element may be satisfied for apportionment of income purposes even though an entity owns less than a 50+% ownership in the entity sought to be included in the unitary business.

2. Section 25102 permits or requires the FTB to permit the finding of unity of ownership when parties are found to be acting in concert with one another.

the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph (A), or one or more other corporations that satisfy the conditions of this subparagraph.

(2) Any two or more corporations, if stock representing more than 50 percent of the voting power of the corporations is owned, or constructively owned, by the same person.

(3) Any two or more corporations that constitute stapled entities.

(A) For purposes of this paragraph, "stapled entities" means any group of two or more corporations if more than 50 percent of the ownership or beneficial ownership of the stock possessing voting power in each corporation consists of stapled interests.

(B) Two or more interests are stapled interests if, by reason of form of ownership restrictions on transfer, or other terms or conditions, in connection with the transfer of one of the interests the other interest or interests are also transferred or required to be transferred.

(4) Any two or more corporations, all of whose stock representing more than 50 percent of the voting power of the corporations is cumulatively owned (without regard to the constructive ownership rules of paragraph (1) of subdivision (e)) by, or for the benefit of, members of the same family. Members of the same family are limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.

(c)(1) If, in the application of subdivision (b), a corporation is eligible to be treated as a member of more than one commonly controlled group of corporations, the corporation shall elect to be treated as a member of only one commonly controlled group. This election shall remain in effect unless revoked with the approval of the Franchise Tax Board.

(2) Membership in a commonly controlled group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subdivision (b) are not met, except as follows:

(A) When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a commonly controlled group shall not be terminated, if the requirements of subdivision (b) are again met immediately after the sale, exchange, or disposition.

(B) The Franchise Tax Board may treat the commonly controlled group as remaining in place if the conditions of subdivision (b) are again met within a period not to exceed two years.

(d) A taxpayer may exclude some or all corporations included in a "commonly controlled group" by reason of paragraph (4) of subdivision (b) by showing that those members of the group are not controlled directly or indirectly by the same interests, within the meaning of the same phrase in Section 482 of the Internal Revenue Code. For purposes of this subdivision, the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.

(e) Except as otherwise provided, stock is "owned" when title to the stock is directly held or if the stock is constructively owned.

(1) An individual constructively owns stock that is owned by any of the following:

(A) His or her spouse.

(B) Children, including adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.

(C) An estate or trust, of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse or children.

(2) Stock owned by a corporation, or a member of a controlled group of which the corporation is the parent corporation, is constructively owned by any shareholder owning stock that represents more than 50 percent of the voting power of the corporation.

(3) Stock owned by a partnership is constructively owned by any partner, other than a limited partner, in proportion to the partner's capital interest in the partnership. For this purpose, a partnership is treated as owning proportionately the stock owned by any other partnership in which it has a tiered interest, other than as a limited partner.

(4) In any case where a member of a commonly controlled group, or shareholders, officers, directors, or employees of a member of a commonly controlled group, is a general partner in a limited partnership, stock held by the limited partnership is constructively owned by a limited partner to the extent of its capital interest in the limited partnership.

(f) For purposes of this section, each of the following shall apply:

(1) "Corporation" means a subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation pursuant to Section 23038 or 23038.5.

(2) "Person" means an individual, a trust, an estate, a qualified employee benefit plan, a limited partnership, or a corporation.

(3) "Voting power" means the power of all classes of stock entitled to vote that possess the power to elect the membership of the board of directors of the corporation.

(4) "More than 50 percent of the voting power" means voting power sufficient to elect a majority of the membership of the board

of directors of the corporation.

(5) "Stock representing voting power" includes stock where ownership is retained but the actual voting power is transferred in either of the following manners:

(A) For one year or less.

(B) By proxy, voting trust, written shareholder agreement, or by similar device, where the transfer is revocable by the transferor.

(g) The Franchise Tax Board may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section, including, but not limited to, regulations that do the following:

(1) Prescribe terms and conditions relating to the election described by subdivision (c), and the revocation thereof.

(2) Disregard transfers of voting power not described by paragraph (5) of subdivision (f).

(3) Treat entities not described by paragraph (2) of subdivision (f) as a person.

(4) Treat warrants, obligations convertible into stock, options to acquire or sell stock, and similar instruments as stock.

(5) Treat holders of a beneficial interest in, or executor or trustee powers over, stock held by an estate or trust as constructively owned by the holder.

(6) Prescribe rules relating to the treatment of partnership agreements which authorize a particular partner or partners to exercise voting power of stock held by the partnership.

(h) This section shall apply to income years beginning on or after January 1, 1995.

(As amended by Ch. 1243, Laws 1994; Ch. 605, Laws 1997, applicable retroactively to income years beginning on or after January 1, 1955.)

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The following examples illustrate the types of factual circumstances that may or may not satisfy the “unity of ownership” element of this test. These examples are for illustrative purposes only and do not limit the number or types of factual circumstances that exist that may or may not satisfy this element:

- a. Pulpwood Furniture, Inc. (“P”) has purchased 50.1% of the outstanding voting shares of Sapwood Manufacturing Co., Inc. (“S”). For purposes of the “unity of ownership” requirement, P directly owns more than a 50% ownership interest of S.
- b. Instead of directly purchasing stock in S, P purchases 80% of the outstanding shares of a Middle Co., Inc., which owns 70% of the outstanding shares of S. For purposes of the “unity of ownership” requirement, P indirectly owns more than a 50% ownership interest of S. *[ALTERNATIVE A (CA): P is considered as indirectly owning 70% of the voting interest of S.] [ALTERNATIVE B: P is considered as indirectly owning 56% (80% x 70%) of the voting interest of S.]*
- c. Same facts as in b. above, but P has purchased only 51% of Middle Co., Inc. which, in turn owns 70% of S. *[ALTERNATIVE 1 (CA): For purposes of the “unity of ownership” requirement, P indirectly owns more than a 50% ownership interest of S. P is considered as indirectly owning 70% of the shares of S.] [ALTERNATIVE 2: For purposes of the “unity of ownership” requirement, P indirectly owns less than a 50% ownership interest of S. P is considered as indirectly owning 35.7% (50.1% x 70%) of the shares of S.]*
- d. Same facts as in b. above, except that P has agreed with the minority shareholders of S that it would assign to an independent third person the right to vote all of P’s shares of Middle Co., so long as P was in the furniture business. P’s

indirect ownership of more than 50% of S's shares satisfies the "unity of ownership" test, even though P does not control S.

- e. P has purchased 50% of the outstanding shares of S and also holds warrants to purchase an additional 10% of S's treasury shares at a nominal price. *[ALTERNATIVE A (CA): P is treated as owning more than 50% of the ownership interest in S even though it has yet to exercise its right to purchase additional shares of S under its warrants.] [ALTERNATIVE B: P is treated as not owning more than 50% of the shares of S, because it has not yet exercised its right to purchase more shares under its warrants.]*

2. The "unity of operations" element of this test is satisfied when each entity or segment within such entity that is to be included within the unitary business receives services, support, guidance or direction from common staff resources, personnel or functions.

The following examples illustrate the types of factors, the existence or non-existence of which assists in the determination of whether the "unity of operations" element of this test has been satisfied. The existence or non-existence of any one factor, by itself, is normally not determinative of whether the element has or has not been satisfied. These examples are for illustrative purposes only and do not limit the number or types of factual circumstances that exist that may or may not satisfy this element:

- a. *Common purchasing:* Corporation P and its wholly owned subsidiary S are manufacturers of furniture; but P manufactures its own line of contemporary furniture and S manufactures reproductions of antique furniture. Both jointly purchase the wood pieces necessary for their production from the same company.
- b. *Common advertising:* Corporations P and S employ the same advertising firm that purchases advertising space in national magazines.
- c. *Common sales force:* Both P and S use the same independent contractor to sell their respective furniture lines to retailers around the United States.
- d. *Common accounting:* For most accounting purposes, P relies on its internal accounting department. S also uses P's accounting.
- e. *Common legal support:* For most non-litigation purposes, P uses its in-house counsel. S also uses P's in-house

counsel for its non-litigation legal needs. P's General Counsel oversees all litigation concerning P and its subsidiaries.

- f. *Common retirement plan*: P has created and adopted one joint retirement plan for employees of P and any of its subsidiaries.

P and S had different retirement plans. Instead of merging the two or terminating both retirement plans and creating another, P sweetened its plan to approximate S's plan, along with a provision that permits service in either entity to qualify as service under either plan.

- g. *Common insurance coverage*: After its acquisition, S's employees were required to enroll in P's health care plan and S's old plan was terminated.
- h. *Common marketing*: The internal marketing department of P provides all of the marketing requirements of both P and S.
- i. *Common cash management*: Both P and S maintain separate bank accounts for their operating fund needs. However, on a quarterly basis, P requires S to pay over to P's Treasurer all excess cash not needed for the operation of S's day-to-day operations. P's Treasurer then invests P's and S's excess cash in a mixture of short and long-term investments.
- j. *Common research and development*: Before P had acquired S, S had a highly accomplished research lab team that specialized in the development and use of various resins necessary in finishing of furniture. P had full access to the use of S's lab.
- k. *Common offices*: After acquiring S, P enlarged the premises of its lease for its offices to add another floor. P subleases the added floor to S.
- l. *Common manufacturing facilities*: After P acquired S, P moved a part of its lathing operation into the factory that S occupies. P then acquired additional space for manufacturing down the block from S's factory to maximize the efficiency of its lathing operation in S's building.
- m. *Common warehousing facilities*: P owns a warehouse in which it stores its entire inventory. After acquiring S, P permitted S to store some of its furniture production in the warehouse.

- n. *Common transportation facilities:* P and S use the same common carrier for their shipments of furniture. Due to the overall volume shipped by P and S, P is given a small discount by the carrier.
- o. *Common computer systems and support:* After its acquisition by P, S got rid of all of its typewriters and bought computer equipment that would network with P's. P's Information Systems people assisted in the integration of the two systems and now fully support S's systems and computer needs. S pays P for the cost of P's providing these computer services at an arms-length hourly rate.
- p. *Financing support:* In order to acquire S, P was required to take out a loan from its bank. The bank insisted on having S's assets pledged as additional collateral for the loan.

When required by bank officers, P would guarantee loans made to S.

3. The 'unity of use' element of this test is satisfied when each entity or segment within such entity that is to be included within the unitary business receives services, support, guidance or direction from common line or executive resources, personnel, or functions.

The following examples illustrate the types of factors, the existence or non-existence of which assists in the determination of whether the "unity of use" element of this test has been satisfied. The existence or non-existence of any one factor, by itself, is normally not determinative of whether the element has or has not been satisfied. These examples are for illustrative purposes only and do not limit the number or types of factual circumstances that exist that may or may not satisfy this element:

- a. *Common management:* One or more of P's inside Board of Directors members are also members of S's Board membership.

P's Chief Operating Officer is the President of S.

- b. *Control of major policies:* P's Board of Directors requires that it approve any acquisition by either P or S of any interest in any other company.

P's Board of Directors requires that it approve any lending of in excess of a minimum set amount to any one or more of either P or S's suppliers.

- c. *Inter-entity transactions*: S has licensed to P the use of a resin developed in S's lab. P uses the resin for its production.
- d. *Common policy/training manuals*: P's Employee Handbook has been expanded to apply to all of S's employees.
S's employees are required to attend P's employee training courses.

Disciplinary procedures are the same for both P and S's employees, although the appeal is only through their respective entities.
- e. *Required budgetary approval*: P's Board of Directors requires that it approve the budget and expenditure plans of S on an annual basis.
- f. *Required capital asset purchase approval*: P's Board of Directors requires that it approve any capital expenditure by S in excess of a minimum set amount.